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# Finding a new equilibrium

**Why the infrastructure sector is reaping the rewards of global mega-trends...**

Update
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Striking the optimal balance between risk and reward remains a perennial challenge for investors. Three-time world heavyweight champion Muhammed Ali is quoted as saying "he who is not courageous enough to take risks will accomplish nothing in life" and, indeed, the highest-returning investments have often rewarded those investors with the strongest constitution for risk.

To this end, a vast array of ready-made portfolios seeks to tempt investors with a choice of risk-themed menus, from "conservative" (heavy in lower-risk, lower-yielding bonds) to "adventurous" (packed with higher-risk, higher-returning equities) or somewhere in the middle for the more indecisive amongst us.

Over the past year or so, more gung-ho investors have undoubtedly reaped the rewards of harnessing their fortunes to the US equity juggernaut but, as we are repeatedly reminded, past performance is not a reliable indicator of future returns and this may well be an opportune time for investors to recalibrate the risk-reward balance in their portfolios.

The chart below shows the expected annualised returns for different asset classes over the next decade according to boffins at BlackRock. Starting with US equities, the forecast 4% average annualised return is on a par with 'lower-risk' government and corporate bonds, although this rises to a more appealing 7% for those willing to move up the risk profile to emerging markets. However, the top-returning asset may come as more of a surprise, with direct lending topping the table at a forecast annualised return of 10%.

## Fig.1: Direct lending is forecast to deliver the highest returns

Source: BlackRock Investment Institute, May 2024 (based on central expected returns for 2024-2034).
***Future performance is not guaranteed and these estimates may prove to be wrong. Capital is at risk.***

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Direct lending has typically been the preserve of institutional investors but this has changed in recent years, with investment trusts tapping into the high-growth infrastructure market to provide exposure to private debt for retail investors. Within direct private lending strategies, infrastructure debt offers a number of distinct and attractive selling-points, with typical features including stable returns with the ability to pass through cost inflation, low cyclicality, a strong asset base and high barriers to entry.

One trust offering exposure to the theme, **Sequoia Economic Infrastructure Income (SEQI)**, aims to provide equity-like returns from providing private debt for infrastructure projects, backed by tangible physical assets. SEQI generates a high yield from a highly defensive portfolio of BB/B credit quality investments, with a target annual return of 7-8% on net asset value, which it has exceeded in its last financial year (to 31/03/2024).

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## Strong secular growth drivers

The infrastructure sector will play a critical role in supporting global mega-trends such as digitalisation and decarbonisation. Private infrastructure assets under management topped more than $1trn last year and global expenditure on physical assets to meet net-zero commitments alone will require a near three-fold increase until 2050, according to McKinsey.

Renewables, waste and energy services, which underpin hopes for a green energy transition in Europe and North America, account for the lion's share of privately-held infrastructure assets,. Another key growth sector is digital infrastructure, which encompasses fixed and mobile networks, cloud computing and AI, with the exponential growth in computing power requiring ever-bigger data centres.

Finally, urbanisation, electrification and the growth in e-commerce is fuelling demand for transport and logistics infrastructure. Charging infrastructure remains a bottleneck for the mass adoption of electric vehicles and demand for manufacturing and logistics facilities has soared as companies seek to 'reshore' supply chains amid heightened geopolitical tensions.

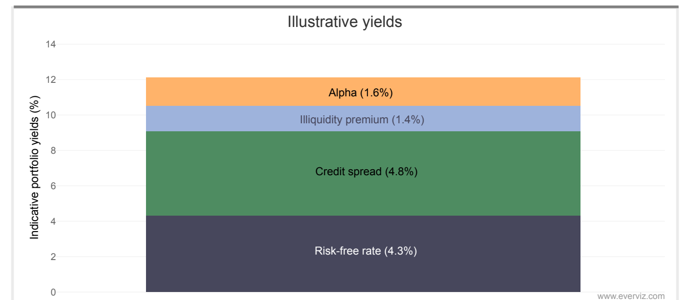
With demand for infrastructure booming, private capital will be needed to bridge the gap in financing caused by constraints on public spending in developed economies due to record levels of public debt. The World Economic Forum estimates that the global funding gap will exceed $15trn by 2024, although this pales into insignificance against the $50trn of estimated incremental capital investment required to slow global warming over the next 25 years.

The US provides a good illustration of the scale of this fiscal imbalance. After decades of under-investment in infrastructure, Congress passed its $1trn infrastructure investment bill in 2021, followed by the Inflation Reduction Act in 2022 which included substantial tax credit for investments in renewables. Even if funding continues at these elevated levels, the ASCE (American Society of Civil Engineers) recently projected a funding gap of more than $3trn in the period up to 2030), creating a substantial opportunity for private debt providers.

## A unique opportunity

SEQI generates a high yield from a strongly-defensive portfolio of BB/B credit quality investments, meaning that the additional yield above the liquid bond benchmarks is generated from the illiquidity and complexity of arranging private debt, rather than taking on additional credit risk, as shown in the chart below:

### Fig.2: Breakdown of yields




Source: SEQI, based on a US loan illustration (as at 29/02/2024)

The managers can also position the floating versus fixed-rate element of the portfolio to take advantage of interest rate changes and have tilted the portfolio towards fixed-rate investments in recent months to lock in rates ahead of what they see as a likely fall in base rates.

Due to its specialist nature, private lending requires a high level of expertise and the SEQI managers, Randall Sandstrom (CEO and CIO), Steve Cook (head of portfolio management) and Dolf Kohnhorst (head of infrastructure), boast a combined experience of more than 80 years in debt capital markets.

As a result, the managers can leverage their impressive network of connections to support the origination of deals, totalling more than 240 over the last nine years. SEQI can also lend on a bilateral basis (as the sole arranger and lender on nearly half of its deals) while also being a preferred partner to a number of other lenders.

While trusts of this type have a specific focus on an individual sector (such as renewables or digital infrastructure), SEQI offers a broad spread of infrastructure assets, providing a 'one-stop' shop for infrastructure exposure.

The portfolio of around 55 investments is diversified across eight sectors, 30 subsectors and 11 mature jurisdictions, with over half of the portfolio invested in more defensive sectors (including accommodation, utilities and renewables). SEQI is one of a small number of listed infrastructure trusts with exposure to the US market (about half of the portfolio) which, as mentioned earlier, is a large market with a substantial requirement for private infrastructure debt.

The managers also seek to manage downside risk for investors by focusing on operational rather than construction assets, which have more predictable income streams, and projects with a significant equity cushion to absorb losses (if needed). Infrastructure loans also typically have lower default rates than other corporate credit classes. The portfolio has a short average life of

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around four years, which reduces interest rate sensitivity and allows to the managers to take advantage of new thematic opportunities as they arise.

Turning to performance, returns should be almost entirely generated by income, as ultimately the trust expects to receive back what it has lent, plus income. However, and with no guarantees, there is the potential for modest capital growth at the moment given that some loans have had to be written down in light of rising interest rates. SEQI has achieved a net asset value total return of 10% and 28% over one and five years respectively and has an attractive current year target dividend yield of 8.4% (as at 29/07/2024).

Clearly, infrastructure is a key element of energy transition and digitalisation. Against that backdrop investors looking for a high income from a debt-based investment, together with a highly-diversified exposure to this specialist theme, may want to take a closer look at SEQI **here**.

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